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IN THE

Supreme Court of the United States

October Term, 1970

No. 5-34

CALLAHAN MINING CORPORATION & SUBSIDIARY,
PINNACLE EXPLORATION, INC.,
Petitioners,

against

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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TABLE OF CONTENTS

	PAGE
Opinions Below	1
Jurisdiction	2
Questions Presented	2
Statutes and Regulations Involved	3
Statement of the Case	3
A. Proceedings and Jurisdiction	3
B. Background and Lease Provisions	3
C. Lease Operations and Income Tax Return Treatment	6
Reasons for Granting the Writ	8
I. The decision of the Court of Appeals is in conflict with the decision of this Court in *Helvering* v. *Mountain Producers Corp.*	8
II. The decision of the Court of Appeals in this case, and decisions handed down in other Circuits on similar subject matter, present a recurring and important question as to apportionment of the depletion deduction, which should be decided by this Court	10
Conclusion	18
Appendix A—Judgment of the Court of Appeals for the Second Circuit	1a
Appendix B—Decision of the Tax Court	3a
Appendix C—Opinion of the Court of Appeals for the Second Circuit	4a
Appendix D—Opinion of the Tax Court	14a
Appendix E—Statutory Provisions and Regulations	44a

Table of Citations

CASES: PAGE

Comm. v. Felix Oil Co., 144 F.2d 276 (9th Cir. 1944) 13, 14, 14n, 15
Comm. v. J. S. Abercrombie Co., 162 F.2d 338 (5th Cir. 1947) 12
Farwell v. Comm., 35 T.C. 454 (1960) 13
Grandview Mines v. Comm., 282 F.2d 700 (9th Cir. 1960) 13
Handelman v. United States, 357 F.2d 694 (Ct. Cl. 1966) 15, 16, 16n
Helvering v. Mountain Producers Corp., 303 U.S. 376 (1938) 2, 8, 9, 10, 11, 13, 14, 16, 17
Herndon Drilling Co. v. Comm., 6 T.C. 628 (1946) 12
Manahan Oil Co. v. Comm., 8 T.C. 1159 (1947) .. 12, 16
Palmer v. Bender, 287 U.S. 551 (1933) 12
Prater v. Comm., 273 F.2d 124 (5th Cir. 1959) 12
Reynolds v. McMurray, 60 F.2d 843 (10th Cir. 1932), *cert. denied*, 287 U.S. 664 ..... 12, 13, 14n
U.S. v. Cocke, 399 F.2d 433 (5th Cir. 1968), *cert. denied*, 394 U.S. 922 12
U.S. v. Thomas, 329 F.2d 119 (9th Cir. 1964) *cert. denied*, 379 U.S. 819 ..... 12, 13, 14, 15

STATUTES:

Section 611, Internal Revenue Code of 1954 ..... 2, 3, 10
Section 613, Internal Revenue Code of 1954 3

REGULATIONS:

Treas. Regs. § 1.611-1(c)(2) 3, 10n

MISCELLANEOUS:

Arthur Andersen & Co., Oil and Gas Federal Income Tax Manual (1966) 12, 16
Galvin, *The "Ought" and "Is" of Oil-and-Gas Taxation*, 73 Harv. L. Rev. 1441 (1960) 12
Miller, Oil & Gas Federal Income Taxation (1969) 11

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioners respectfully pray that a writ of certiorari issue to review a judgment of the United States Court of Appeals for the Second Circuit, affirming a decision of the Tax Court of the United States. A copy of the judgment of the Court of Appeals sought to be reviewed is set forth in Appendix A to this petition. A copy of the decision of the Tax Court is set forth in Appendix B to this petition.

Opinions Below

The opinion of the Court of Appeals, delivered upon the rendering of the above described judgment, is set forth in Appendix C to this petition and has not yet been reported.

The opinion of the Tax Court, delivered upon the rendering of the above described decision, is set forth in Appendix D to this petition and is reported at 51 T.C. 1005.

Jurisdiction

The judgment of the United States Court of Appeals for the Second Circuit sought to be reviewed was dated and entered on June 29, 1970. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

Questions Presented

Section 611 of the Internal Revenue Code of 1954 provides that taxpayers are entitled to claim, as a deduction for depletion on mining property, oil and gas wells and similar property, a stated percentage of their gross income from the property, and further provides that "[i]n the case of a lease, the deduction * * * shall be equitably apportioned between the lessor and lessee."

The questions presented for review by this Court are the following:

1. Whether the standard laid down by this Court in *Helvering* v. *Mountain Producers Corp.*, 303 U.S. 376 (1938), that it is improper to "construct a theoretical gross income" for purposes of apportioning the depletion deduction, is satisfied where the Commissioner of Internal Revenue

   (a) allocates to the lessee of a mining property depletion on the portion of gross income used to pay expenses borne by the lessor's share of profits and

   (b) allocates to the lessor of the property depletion only on its share of *net* income and declines to permit the lessor to claim depletion on the portion of gross income used to pay expenses borne by the lessor's shares of profits.

2. Whether the Commissioner's position is reconcilable with the Congressional mandate of "equitabl[e]" apportionment of the depletion deduction as between the lessor and lessee.

Statutes and Regulations Involved

The statutory provisions here involved are Sections 611(a), 611(b)(1), 613(a) and 613(b)(3)(A) of the Internal Revenue Code of 1954, 26 U.S.C. §§ 611(a), 611(b)(1), 613(a) and 613(b)(3)(A). These statutory provisions appear in 68A Stat. 207, 208. The regulation here involved is Section 1.611-1(c)(2) of the Regulations of the Internal Revenue Service, Department of the Treasury, 26 CFR 1.611-1(c)(2), at page 189.

All of such statutory provisions and such regulation are set forth in Appendix E to this petition.

Statement of the Case

A. Proceedings and Jurisdiction

Petitioners Callahan Mining Corporation ("Callahan") and its wholly-owned subsidiary, Pinnacle Exploration, Inc. ("Pinnacle") instituted a proceeding in the Tax Court on July 20, 1966, for redetermination of deficiencies in income taxes asserted by the Commissioner of Internal Revenue for the years 1959, 1960 and 1961.

Jurisdiction was vested in the Tax Court pursuant to Section 7442 of the Internal Revenue Code of 1954, 26 U.S.C. § 7442.

B. Background and Lease Provisions

Callahan was organized in 1912 and, since its incorporation, has been engaged in the business of owning, developing and mining properties. During the early

1920's, it acquired a number of claims in Northern Idaho (herein referred to as the "Galena property") and during the period from 1922 through 1932 spent substantial sums in an effort to make the property commercially productive. During the next fifteen years, Callahan conducted mining operations on the property only sporadically. In 1946 Callahan commissioned a survey by independent engineers which indicated that the mine had considerable potential but that exploitation of that potential would require a program of considerable expense and risk. Because of its limited resources, Callahan was unwilling to undertake this program and therefore, on January 15, 1947, it entered into a lease of the property to American Smelting and Refining Company ("ASARCO").*

Under the terms of the lease agreement, ASARCO was granted the exclusive right to explore, develop and operate the Galena mining property for a term of 30 years with an option to renew for an additional 30 years. After completion of certain specified work on which ASARCO was required to expend no more than $600,000, ASARCO had the right to terminate the lease at any time thereafter upon thirty days written notice. If it did not elect to terminate the lease, ASARCO was obligated to advance the funds necessary to continue exploration and development for so long as it continued the lease and "in its sole judgment" deemed such expenditure advisable for the benefit of the enterprise.

In essence the lease provided for all expenses advanced by ASARCO to be reimbursed to it from "net profits" as

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* The original lessor under the lease agreement was Vulcan Silver-Lead Corporation, a wholly owned corporation organized by Callahan for the purpose of holding the property leased to ASARCO. Vulcan was merged into Callahan in 1958.

ASARCO, soon after the leasing, assigned 25% of its interest to another company. The assignment has no bearing on the issues presented; and, for convenience, the entire lessee's interest is treated here, as it was by the courts below, as owned by ASARCO.

defined in the lease and for "net profits" remaining after such reimbursement to be divided equally between Callahan and ASARCO. Accordingly, the ultimate burden of expenses, following reimbursement of advances, would be borne equally by Callahan and ASARCO. Specifically, the lease provided:

(A) "Net profits" were defined as the cash proceeds released by the venture less expenses of operation and development (including not only current expenses such as royalties and taxes but also capital expenditures) but without allowance for depletion or depreciation.

(B) "Net profits" were to be applied first to reimburse ASARCO for its initial advances.

(C) "Net profits" remaining after such reimbursement would be applied to establish and maintain a working capital fund of $500,000.

(D) "Net profits" in excess of those required to satisfy the foregoing requirements were to be divided equally between Callahan and ASARCO.

(E) If after being reimbursed for initial expenditures ASARCO advanced funds in excess of $75,000 for capital expenditures in any one year, or if ASARCO made advances to continue operations at a loss when working capital was depleted or exhausted, such advances would be treated as loans bearing 5% interest per annum, subject to recoupment out of first profits thereafter derived.

(F) Upon termination of the lease by ASARCO, the working capital fund, and any funds realized on the sale of equipment, material and supplies, were to be divided equally between Callahan and ASARCO. However, ASARCO was first entitled to be fully reimbursed out of working capital and such other funds for its advances, if any, not theretofore reimbursed.

Until ASARCO was reimbursed for its initial expenditures and the working capital fund so established, ASARCO was required to pay a royalty to Callahan in the amount of 10% of the net smelter or mill returns, or 50 cents per ton of crude ore, whichever was greater. (In 1959, after Callahan became entitled to share in profits, the lease was amended to provide that ASARCO would advance to Callahan, in any calendar quarter in which Callahan's share of net profits fell below 50 cents per ton of crude ore produced and sold, the difference between Callahan's share of net profits and 50 cents per ton of such crude ore. Such advances were chargeable against Callahan's share of net profits in any future calendar quarter to the extent that such share exceeded 50 cents per ton of crude ore.)

C. Lease Operations and Income Tax Return Treatment

ASARCO has continued as lessee of the Galena property since 1947 and has continued to use the same two shafts, previously constructed and used by Callahan, in its exploration, development and operation of the Galena property. It has sunk only one additional shaft, but has extended the depths of the original shafts to formations where ore in commercial quantities was found.

The $600,000 minimum expenditure, required of ASARCO by the lease agreement, and all other amounts advanced by ASARCO subject to reimbursement under the lease agreement were in fact recouped by ASARCO out of "net profits" of the Galena property by 1958.

Prior to 1958, all payments made by ASARCO to Callahan were treated as royalty payments by all parties (including Callahan), with ASARCO claiming depletion on gross income less royalty payments.

During 1958, 1959 and all times thereafter ASARCO included in its gross income and claimed depletion on total gross income from the mining properties less pay-

ments to Callahan and Callahan's 50% share of the $500,000 transferred to working capital in 1958 and 1959.

Callahan (which filed consolidated returns with Pinnacle) computed and claimed percentage depletion deductions on its 1959, 1960 and 1961 tax returns based on a 50% share of total gross income from the Galena mining property computed as follows:

	Gross Income from Sales	Applied to Working Capital and Capital Expenditures Amounts	Gross Income to be Apportioned	Callahan's Claimed Share (50%)	Statutory Percentage of Depletion (15%)
1959	$3,236,841	($63,324)	$3,173,517	$1,586,758.50	$238,013.77
1960	$3,423,857	($79,555)	$3,344,302	$1,672,151.00	$250,822.65
1961	$4,568,077	($ 1,551)	$4,566,526	$2,283,263.00	$342,489.45

The Commissioner of Internal Revenue, in his notice of deficiency, allowed Callahan depletion deductions of only 15% of its *net* income from the property as follows:

	Net Income from the Property	Amount Allowed as Depletion (15%)
1959	$618,730	$ 92,728
1960	$586,047	$ 87,907
1961	$838,778	$125,816

The Commissioner's position, in essence, was that ASARCO as lessee of the property was entitled to include in its gross income, for depletion purposes, income used to pay expenses borne by Callahan's share of profits as well as by its own share of profits, and that Callahan as lessor was entitled to claim depletion only on its *net* income from the property.

Reasons for Granting the Writ

I. The decision of the Court of Appeals is in conflict with the decision of this Court in *Helvering* v. *Mountain Producers Corp.*

In *Helvering* v. *Mountain Producers Corp.*, 303 U.S. 376 (1938), this Court held that gross income used to pay expenses was not allocable to the holder of a royalty measured solely by gross income but rather to the holder of the interest affected by the costs of production. The Court held that it was improper "to construct a theoretical gross income" by adding to the taxpayer's income expenses which it did not bear. 303 U.S. at 382.

The logic of *Mountain Producers* compels the conclusion that lessors of mining property and similar property, whose interests are measured by *net* profits, are entitled to depletion based not only on the share of profits distributed to them in cash but also on that portion of gross income used to pay the expenses which diminish that share of profits. To allocate to lessees income used to pay expenses which diminish lessors' incomes would be to "construct a theoretical gross income" for lessees, in square conflict with the principle of *Mountain Producers*.

The decisions of both the Court of Appeals and the Tax Court, in the instant case, accomplish precisely what this Court held should not be done. These decisions construct a theoretical gross income for ASARCO by adding to its one-half share of gross income the additional one-half of the expense items paid out of Callahan's share of income. Conversely, they deprive petitioners of their right to include these items in their own gross income available for depletion.

During the tax years in question (1959, 1960 and 1961), ASARCO had recouped its entire investment in the Galena

property. In these years, each dollar of gross income was first applied to the payment of expenses (including the cost of capital items), and the excess of such income over such expenses was shared equally. The positions of Callahan and ASARCO, then, were essentially parallel and no different from those which would have obtained if the parties had appointed an agent to manage the property for their joint account. For all practical purposes they had an equal interest in the success or failure of the venture and in all items of income and expenses, each of them benefitting equally from all income produced and being affected equally from all expenditures made.

Under these circumstances, it is submitted that the decision below—which allocates about 18% of the total depletion deduction to Callahan and 82% thereof to ASARCO—is irreconcilable with *Mountain Producers*.

Despite the reliance placed upon *Mountain Producers* in petitioners' briefs below, the Court of Appeals did not purport to reconcile its decision with the *Mountain Producers* decision. Instead, the Court of Appeals characterized petitioner's interest in the lease as a "net profit interest"; described the issue before it as "what sharing of risks might so *shift* the economic relationships under the lease agreement that it would be equitable to apportion the depletion allowance equally between the parties" (emphasis added); admitted that such issue "is not without difficulty"; held that the issue was a mixed question of law and fact requiring that "primary weight" be given to the fact-finder's conclusion; and concluded that there was "ample support" for the Tax Court's determination, which was based primarily on a comparison of petitioner's limited risk in the hypothetical event of operations resulting in a loss not covered by the $500,000 working capital "cushion" with ASARCO's potentially greater risk in the same hypothetical event. The Court of Appeals did not explain why, in the face of *Mountain Producers*, a holder

of a "net profits interest" should be denied (or presumptively denied) the benefit of depletion on the portion of gross income represented by expenses reducing its share of profits. Nor did it explain why the allocation of the depletion benefit on such portion of gross income to the other party to the lease, on the theory that it might have borne a greater share of expenses if operations were unprofitable (which they were not), is not precisely the construction of "theoretical gross income" forbidden by *Mountain Producers*.

Accordingly, review by this Court is necessary to resolve the conflict between the decision of the Court of Appeals and that handed down in *Mountain Producers*—a conflict the resolution of which is not even discussed by the decision below.

II. The decision of the Court of Appeals in this case, and decisions handed down in other Circuits on similar subject matter, present a recurring and important question as to apportionment of the depletion deduction, which should be decided by this Court.

The basic question in this case is, of course, the interpretation of the Congressional mandate, contained in Section 611(b) of the Internal Revenue Code of 1954, 26 U.S.C. § 611(b), of "equitabl[e]" apportionment of the depletion deduction as between the lessor and lessee.

The question is a recurrent and important one, affecting lessors and lessees of mining property, oil and gas wells and other property containing natural deposits. All such property is subject to the depletion allowance provided for in Section 611(a) of the Code and the quoted apportionment directive contained in Section 611(b).*

*The applicable regulations are no more specific, and simply track the statutory command of "equitabl[e]" apportionment, verbatim. See Treas. Reg. §§ 1.611-1(c)(2).

The question of apportionment of the depletion deduction in a case such as this is one which—despite its manifest importance—has been litigated in at least four circuits without discernable uniformity of approach or of result. Assuming *arguendo* that, as argued below by the Commissioner of Internal Revenue and ASARCO (appearing as amicus curiae), *Helvering* v. *Mountain Producers Corp.*, *supra*, did not require reversal of the Tax Court's decision, the other precedents in the area are so divergent, despite a spate of litigated cases, as to invite resolution by this Court.

A few definitions will assist consideration of the present state of the law:

1. A "carried interest" arises where one party, referred to as the "carrying party", agrees to pay exploration, development or operating costs of a mineral property attributable both to his interest in such property and to the interest of another party, such other party being referred to as the "carried party". The carrying party recoups advances made by it only out of production from the property.

2. A "limited carry" describes an arrangement under which the carrying party agrees to advance expenses only during the initial development stage of a property, recouping them only out of production from the property. All expenses incurred after recoupment are borne equally by the carrying and carried parties.

3. An "unlimited carry" describes an arrangement under which the carrying party agrees to pay the excess of expenses over income from a particular piece of property at any time during the life of the agreement between the parties, not only during the initial development phase, recouping any such excess expenses paid by it only out of future production. See Miller, *Oil & Gas Federal Income Taxation* 220-35 (1969).

The term "carried interest" as used herein includes so-called "net profits" arrangements under which a lessee

is paid a share of net profits for the life of the lease. Although the legal formalities may differ between a classic "net profits" lease and a "carried interest", they are economically indistinguishable. See *U.S.* v. *Thomas*, 329 F.2d 119 (9th Cir., 1964), *cert. denied*, 379 U.S. 819. It is well established that in determining a taxpayer's right to the depletion allowance, economic substance must prevail over legal formalities. *Palmer* v. *Bender*, 287 U.S. 551 (1933).

Many cases have been concerned with the allocation of income and depletion *during the payout period*. Some have held that income and depletion during the payout period should be allocated in accordance with profit and loss ratios during the post-payout period. *Reynolds* v. *McMurray*, 60 F.2d 843 (10th Cir. 1932), *cert. denied*, 287 U.S. 664; see also *Comm.* v. *J. S. Abercrombie Co.*, 162 F.2d 338 (5th Cir. 1947); *Prater* v. *Comm.*, 273 F.2d 124 (5th Cir. 1959). Others have held that during the payout period all income and related depletion is to be allocated to the carrying party. *U.S.* v. *Cocke*, 339 F.2d 433 (5th Cir. 1968), *cert denied*, 394 U.S. 922, overruling *Comm.* v. *J. S. Abercrombie Co.*, *supra*, and *Prater* v. *Comm.*, *supra*; *Manahan Oil Co.* v. *Comm.*, 8 T.C. 1159 (1947); *Herndon Drilling Co.* v. *Comm.*, 6 T.C. 628 (1946). The first line of cases would, if followed, on *a fortiori* principles, compel the conclusion that depletion after the payout period (such as that in the case at bar) should be allocated to both parties in proportion to their profit and loss ratios. The second line of cases does not purport to determine allocation after the payout period.

Where only a *limited* carry is involved, gross income, including the income used to pay expenses, and related depletion, are allocated *after the payout period* between the parties in the same ratio in which they share in cash flow. Galvin, "The 'Ought' and 'Is' of Oil-and-Gas Taxation", 73 *Harv. L. Rev.* 1441, 1493 (1960); Arthur Andersen & Co., *Oil and Gas Federal Income Tax Manual* 257-59 (1966).

The law is unsettled with respect to the allocation of *post-payout* depletion in the *unlimited* carry case. In the 10th Circuit allocation aparently would be made in accordance with the ultimate profit and loss ratio. *Cf. Reynolds* v. *McMurray, supra.* The 9th Circuit takes a different view. It has held that after payout the carried party is entitled to depletion only on gross income equal to its share of net profits. *U.S.* v. *Thomas, supra; Grandview Mines* v. *Comm.*, 282 F. 2d 700 (9th Cir. 1960); *Comm.* v. *Felix Oil Co.*, 144 F. 2d 276 (9th Cir. 1944). The Tax Court agrees with the 9th Circuit, *Farwell* v. *Comm.*, 35 T.C. 454 (1960). The Court of Appeals for the Second Circuit, in the instant case cautioned that it did "not necessarily indicate agreement with all that was said in the Ninth Circuit's opinions", evidently believing that it was resting on narrower grounds.

It is clear that the decisions handed down by the 9th Circuit and followed by the Tax Court are squarely based on a misinterpretation of the decision of this Court in *Helvering* v. *Mountain Producers Corp., supra.* In *Comm.* v. *Felix Oil Co., supra*, the Court of Appeals for the Ninth Circuit considered a case involving a lease by a taxpayer to a lessee for a 50% net profits interest. The court held that the taxpayer was entitled to compute depletion only on the amount actually received by it and rested its decision on its interpretation of *Mountain Producers* saying:

> "... As we read the opinion in *Helvering* v. *Mountain Producers Corp., supra*, a contention virtually identical with that made by the taxpayer here was rejected, the court saying (p. 382) that it was not 'at liberty to construct a theoretical gross income by recourse to the expenses of production operations.'" (144 F.2d 276, 278)

The interest possessed by the taxpayer in *Felix Oil, supra*, was, however, burdened with the costs of operations unlike that of the taxpayer in *Mountain Producers;* and, accordingly, for the reasons stated in Point I, *supra*, the taxpayer

in *Felix Oil* should have been allowed to include in its income the gross income used for the payment of such expenses.

Cases following *Felix Oil* have not reconsidered the impact of *Mountain Producers*, but instead have cited *Felix Oil* as controlling. The entire line of cases beginning with *Felix Oil* and ending with *U.S.* v. *Thomas*, *supra*, is based upon a misapplication of this Court's decision in *Mountain Producers* and reached results exactly contrary to those which would follow from a correct application of that case.

As mentioned above, the Court of Appeals for the Second Circuit explicitly declined to endorse *Felix Oil* and the cases following it, even though—as it recognized—the Tax Court relied on that line of cases in reaching its decision in the instant case.* The Court of Appeals evidently believed that its decision rested on narrower grounds, *i.e.* a comparison of the extent of petitioner's and ASARCO's respective risks in the event of a hypothetical loss operation. We have pointed out at Point I, *supra*, that this position is irreconcilable with *Mountain Producers*. Even more significant for this discussion, it establishes *still another conflicting test* for allocation of the depletion deduction. Indeed, the test in the instant case produced a result adverse to petitioners even though the facts differed from those in *Felix Oil* and the result by the Court below is not dictated by *Felix Oil* and the ensuing line of cases. In none of these cases did the "carrying" party insulate itself from any practical risk of loss by its complete control of

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* The Tax Court stated that "every decision which retains its vitality * * * has concluded that, even in the post-recoupment period, the holder of a net profit interest is entitled to depletion only on the *amounts he receives*" (emphasis in original). It cited for this view *Felix Oil*, other Ninth Circuit cases following it and decisions of the Tax Court itself. It stated that the contrary decision of the Court of Appeals for the Tenth Circuit in *Reynolds* v. *McMurray*, *supra*, was "moribund", although it did not cite any cases (nor do we know of any) in support of that statement.

operations, its right to cancel the agreement and the creation of a cushion against loss in the form of a $500,000 working capital fund accumulated out of net profits. In fact, none of the *Felix Oil* line of cases, except *United States v. Thomas, supra*, involved any provision for a working capital fund, and the working capital fund in *Thomas* was $25,000, as opposed to $500,000 in the instant case. Thus, the Second Circuit now has adopted a third—and in this case more onerous—test for allocation of the depletion deduction following the payment period.

Yet a fourth approach is suggested by the decision of the Court of Claims in *Handelman v. United States*, 357 F. 2d 694 (Ct. Cl. 1966). There, the Court of Claims permitted the lessor to claim depletion with respect to certain amounts paid by the lessee to discharge state ad valorem taxes. The lessee contended that this deduction should be denied the lessor because the tax was payable annually regardless of whether there was in fact production from the property and consequently might in some years be in the nature of a delay-rental rather than an amount paid out of mineral production. The court, while conceding this, said:

> "There is no apparent reason why the ad valorem tax payments cannot be fragmented into annual units to determine whether each is production income or in the nature of a delay-rental. There is no present necessity for determining whether amounts to be received a half century from now will come from production or not. It will be known, when each annual tax report is filed, whether there was sufficient production to cover the payment of the taxes. It is agreed that simplicity in the application of the depletion provisions is desirable but, whenever possible, the court should avoid arriving at unrealistic results in the name of simplicity. The Government itself has chosen the 12-month year as the taxpaying unit. It should, in turn, allow the taxpayer to use a similar unit to determine if he has, in fact, suffered any depletion of his resources." 357 F. 2d at 703.

We believe that application of the *Handelman* principle would produce a fair result and one which would in all respects be consistent with *Mountain Producers*. Thus, in the instant case, the lease agreement would be viewed as contemplating an initial "carry" covering initial exploration and development expenses to be paid by ASARCO, and possible future "carries" which might arise in the event ASARCO chose to pay the excess, if any, of expenses over income for a future period rather than cancel the lease between the parties.* Under such circumstances gross income devoted to the reimbursement of ASARCO during the initial payout period or during any later payout period resulting from ASARCO's election to carry taxpayer would, with related depletion deductions, be allocable to ASARCO. Gross income (such as that in the years at issue) arising in a period other than a payout period would be divided equally between the parties.

The result thus obtained would be consistent with the established principles governing treatment of "limited carry" interests. See *Manahan Oil Comm*, *supra*, Galvin, *op. cit.*, and Arthur Andersen & Co., *op. cit.* In the case of a limited carry, after the end of the payment period, no further attention is paid to the initial investments of the parties nor to the allocation of income during the period those investments are being recouped. Instead, once the parties begin to share equally in each dollar of income received and each dollar of expense paid, they are viewed

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* The Court in *Handelman* attached substantial importance to the lessee's right to cancel, stating:

> "Little business acumen is needed to know that when it appears that further production will not be adequate to cover direct operating expenses and the ad valorem taxes, the lessee will terminate the lease and the obligation for the taxes will revert to the lessor". *Ibid.*

ASARCO too doubtless would promptly cancel the lease if, at a future date, it thought its operations would result in any meaningful risk of unreimbursed loss.

as having an equal interest in the gross income from the property and consequently in the depletion.

The logic of *Mountain Producers* suggests that "limited carries" and "unlimited carries" should be treated in exactly the same way so long as the "carrying" party's risk of loss in the post-payout period is merely a hypothetical one. Otherwise, the courts will have created "theoretical gross income" for the "carrying" party by adding to that party's income expenses which do not burden that share of income. If a burden does result in a future year, tax treatment would revert to that of the initial payout period and income used to pay the additional expenses borne by the "carrying" party could be included in its gross income. In this way, tax treatment would reflect the actual burden of expenses, and the courts would avoid creating a discrepancy in net income after tax where none existed before tax.

In any event, regardless of which rule is adopted, it is clear that those affected by apportionment of depletion have been left to swim in murkey waters by the at-least-dubious construction of *Mountain Producers* by the 9th Circuit, the conflicting approach of the Court of Claims, the uncertain effect on the post-payout period of the overruling decisions handed down by the 5th Circuit, the Tax Court's suggestion that the 10th Circuit pre-payout rule is "moribund" and, most recently, the decision of the Court of Appeals for the Second Circuit in the instant case expressing reservations as to the 9th Circuit and Tax Court cases and adopting still another test. In the present state of matters, a definitive statement by this Court is, we submit, imperative.

CONCLUSION

For the reasons set forth herein, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX A

Judgment of the Court of Appeals for the Second Circuit

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the twenty-ninth day of June, one thousand nine hundred and seventy.

Present:

HON. J. JOSEPH SMITH,
HON. PAUL R. HAYS,
Circuit Judges.

HON. JOHN R. BARTELS,
District Judge.

[DOCKET NOS. 34070, 34166].

CALLAHAN MINING CORPORATION & SUBSIDIARY,
PINNACLE EXPLORATION, INC.,

Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellant.

Appeal from The Tax Court of the United States.

Appendix A

This cause came on to be heard on the transcript of record from The Tax Court of the United States and was argued by counsel.

On Consideration Whereof, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is affirmed in accordance with the opinion of this court with costs to be taxed against the appellants, Callahan Mining Corporation & ano.

It is further ordered, adjudged and decreed that cross-appeal of the Commissioner of Internal Revenue be and it hereby is dismissed as moot.

A. Daniel Fusaro,
Clerk.

By Vincent A. Carlin,
Chief Deputy Clerk.

APPENDIX B

Decision of the Tax Court

TAX COURT OF THE UNITED STATES

Docket No. 4231-66

CALLAHAN MINING CORPORATION & SUBSIDIARY,
PINNACLE EXPLORATION, INC.,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the opinion of the Court filed March 24, 1969, and the agreed computation of tax liability filed by the parties; and incorporating herein the facts recited in the computation as the findings of the Court, it is

ORDERED and DECIDED: That there are deficiencies in income taxes due from the petitioner for the taxable years 1959, 1960 and 1961 in the amounts of $112,585.06, $76,469.34 and $114,494.56, respectively.

/s/ THEODORE TANNENWALD, JR.
Judge

Entered: June 17, 1969

APPENDIX C

Opinion of the Court of Appeals for the Second Circuit

[Entered June 29, 1970]

UNITED STATES COURT OF APPEALS

For the Second Circuit

Docket Nos. 34070, 34166

Callahan Mining Corporation & Subsidiary,
Pinnacle Exploration, Inc.,
Petitioners-Appellants,

v.

Commissioner of Internal Revenue,
Respondent-Appellee.

Callahan Mining Corporation & Subsidiary,
Pinnacle Exploration, Inc.,
Cross-Appellees,

v.

Commissioner of Internal Revenue,
Cross-Appellant.

Hays, *Circuit Judge*:

This appeal concerns the proper allocation of the percentage depletion deduction between the lessor and the

lessee of certain mining property. The Tax Court determined that an allocation of the depletion deduction to the lessor, appellant Callahan Mining Corporation, based upon the fifty percent share of net profits payments which it received under the terms of the lease represented an "equitable apportionment" satisfying the mandate of the relevant provision of the Internal Revenue Code of 1954, § 611(b)(1). Callahan contends that its depletion deduction should be based upon fifty percent of the total gross income from the property. We find no reason to disturb the determination of the Tax Court,[1] and accordingly, we affirm its decision that there are deficiencies due from appellant for the years 1959, 1960 and 1961 in the amounts of $112,585.06, $76,469.34 and $114,494.56, respectively.

I.

The following summary of the facts as found by the Tax Court, 51 T.C. No. 103 (March 24, 1969), is sufficient for an understanding of the issue involved in this case.

On January 15, 1947, appellant Callahan entered into a lease agreement with American Smelting and Refining Company (ASARCO) with respect to certain contiguous patented and unpatented lode claims in the Coeur d'Alene District in Northern Idaho. These claims, known as the Galena mining property, had been acquired by appellant in the early 1920's, and between 1922 and 1938 appellant had expended substantial sums on exploration and development of the property in an unsuccessful attempt to achieve commercial production. In 1946, after a period of inactivity at the mining property, independent engineers hired by appellant conducted an examination of the prop-

[1] In view of our decision it is unnecessary for us to reach the issues raised on the Commissioner's "protective" cross-appeal and the cross-appeal is therefore dismissed.

erty's potential. Their report indicated that, in view of recently discovered valuable deep ore bodies in the vicinity of the Galena mining property, a deep exploration program was warranted, but that such a program would involve a substantial financial risk. Appellant, either unwilling or unable to undertake the risk itself, began negotiations with several major mining companies in an effort to secure outside financing. The lease agreement entered into with ASARCO was the result.[2]

Under the terms of the lease agreement, ASARCO was granted the exclusive right to explore, develop and operate the Galena mining property for a term of 30 years with an option to renew for an additional 30 years. After completion of certain specified work on which ASARCO was required to expend no more than $600,000, ASARCO had the right to terminate the lease upon thirty days written notice. If it did not elect to terminate the lease, ASARCO was obligated to continue "with reasonable diligence" the exploration and development of the property; however, all exploratory, development and operational work was to be undertaken only as ASARCO "in its sole judgment" deemed advisable for the benefit of the enterprise. All moneys required for such work, including working capital, were to be advanced by ASARCO. ASARCO was also required to pay all taxes upon the property and to reimburse Callahan for any taxes paid by it.

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[2] The original lessor under the lease agreement was Vulcan Silver-Lead Corporation, a wholly owned corporation organized by Callahan for the purpose of holding the property leased to ASARCO. At the time of the transfer of the Galena mining property to Vulcan, appellant's investment in the property amounted to approximately $1,555,475.50. Vulcan was merged into appellant in 1958.

The lessee ASARCO assigned one-quarter of its interest in the leased property to Fern Mining Company, which in turn assigned the interest to Day Mines, Inc., its present owner.

Appendix C

Net profits[3] were to be applied first to reimburse ASARCO for its advances or expenditures in connection with the exploration, development and operation of the mining property and then to establish and maintain a working capital fund of $500,000. Article 14 of the lease agreement provided that any net profits in excess of those required to satisfy the foregoing requirements were to be divided "equally between the Lessor and the Lessee." Until such time as the lessor Callahan was entitled to share in the net profits of operations, ASARCO was required to pay royalties to Callahan on all ores and concentrates produced and sold in an amount equal to ten percent of the net smelter or mill returns.[4] However, these royalties were to be not less than fifty cents per ton of crude ore.

If, after the profit-sharing provision had become operative, Callahan's share of net profits during any calendar quarter fell below fifty cents per ton of crude ore produced, Article 17 required ASARCO to advance to Callahan the difference between Callahan's share of net profits for the quarter and the sum of fifty cents per ton of crude ore. These advances were chargeable against Callahan's share of net profits in any future calendar quarter to the extent that such share exceeded fifty cents per ton of crude ore, but Callahan was not otherwise liable for the repayment of the advances.

Finally, in Article 29, the lease agreement provided that upon termination of the lease ASARCO was required to surrender the property and to pay all bills and other obligations incurred in connection with its development and

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[3] Net profits were determined by deducting from the net proceeds of crude ores, concentrates and other products of the property, the total expenses of operating the property, including royalties and taxes but not depletion or depreciation.

[4] Net smelter or mill returns were defined as the net amount received from the smelter or mill for ores or concentrates less costs of transportation and smelter or mill charges.

operation including all royalties and profits due to Callahan up to the date of termination. To the extent that ASARCO had not been fully reimbursed for expenditures made by it under the terms of the contract, including advances to Callahan under the provisions of Article 17, the working capital fund, including all equipment, material and supplies, was to be applied to satisfy ASARCO's claims. Any remaining amount in the working capital fund was to be divided equally between Callahan and ASARCO.

Since 1947, ASARCO has operated the Galena mining property under the terms of the lease agreement with its own employees and management team, expending substantial amounts in exploration, development and equipment. The operation began to show a profit in 1955, and by January 1959, sufficient net profits had been generated to reimburse ASARCO for its prior expenditures (totalling $3,641,079) and to establish the $500,000 working capital fund. Since that time and during the years 1959-1961 here in issue, appellant and ASARCO have divided net profits equally. During late 1959 and early 1960, because of a strike at the smelters, ASARCO advanced approximately $800,000 over and above the $500,000 working capital account in order to keep the mine in operation. These advances were subsequently recovered from net profits.

On its federal income tax returns for the years 1959, 1960 and 1961, appellant computed and claimed percentage depletion deductions based on fifty percent of the total gross income of the Galena mining property. The Commissioner ruled that appellant was entitled to depletion deductions based only on the amounts it actually received from ASARCO as its share of net profits.[5] Appellant filed a petition for redetermination in the Tax Court. The Tax Court held adversely to appellant, determining deficiencies

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[5] Appellant received payments of $534,501 in 1959, $586,047 in 1960 and $838,778 in 1961.

due for the taxable years 1959, 1960 and 1961 in the amounts of $112,585.06, $76,460.34 and $114,494.56, respectively.[6]

II.

Section 611(a) of the Internal Revenue Code of 1954 authorizes, as a deduction in computing taxable income from mines and other natural deposits, a "reasonable allowance for depletion . . . according to the peculiar conditions in each case. . . ." The allowable deduction in the case of metal mines is 15 percent of the "gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property." Int. Rev. Code of 1954, § 613(a), (b)(3). In the case of a lease, Section 611(b) directs that the deduction "shall be equitably apportioned between the lessor and the lessee."

The Tax Court, having examined the lease agreement between ASARCO and appellant, concluded that "Under the circumstances of this case . . . an allocation of the depletion deduction to [Callahan] based upon the amounts it actually received best satisfies the mandate of equitable apportionment under Section 611(b)(1)."

A taxpayer may share in the depletion allowance only to the extent that he has an economic interest in the extraction and sale of the mineral for which depletion is claimed. See *CIR* v. *Southwest Exploration Co.*, 350 U.S. 308 (1956); *Palmer* v. *Bender*, 287 U.S. 551, 557 (1933).

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[6] On its federal income tax returns for the years 1959, 1960 and 1961, ASARCO claimed depletion deductions based on the total gross income from the Galena mining property, less payments to petitioner and $250,000 of the working capital account. The Commissioner subsequently disallowed depletion claimed by ASARCO to the extent that such depletion, when added to the depletion allowed to petitioner, would exceed 15 percent of the total gross income from the Galena mining property.

Thus the central inquiry in apportioning the depletion deduction between the parties to a lease agreement, is whether a party has "an economic interest in the working interest," see *United States* v. *Thomas*, 329 F.2d 119, 130 (9th Cir.), cert. denied, 379 U.S. 819 (1964), supporting a deduction for depletion based on the gross income from the property, or has merely an economic interest in the ore in place, a non-operating interest supporting depletion deductions based only on the amounts actually received by the party as the resource is extracted and sold. See *Burton-Sutton Oil Co.* v. *CIR*, 328 U.S. 25, 35 (1946); *Kirby Petroleum Co.* v. *CIR*, 326 U.S. 599, 604-05 (1946); *Helvering* v. *Mountain Producers Corp.*, 303 U.S. 376, 382 (1938). In determining what constitutes an equitable apportionment, the courts have focused on the question of who bears the financial burdens of development and operation. See, e.g., *United States* v. *Cocke*, 399 F.2d 433, 445-47 (5th Cir. 1968), cert. denied, 394 U.S. 922 (1969). See generally, Galvin, The "Ought" and "Is" of Oil-and-Gas Taxation, 73 Harv. L. Rev. 1441, 1492-95 (1960). Applying these principles in a line of cases, the Ninth Circuit has held that where the lessee has sole control over operations, furnishes all the capital for exploration and development, and is solely liable for the loss if the operation should prove unprofitable, the lessor retaining an economic interest in the depletable resource holds essentially a net profits, non-operating, interest and is entitled to depletion only on the amounts he actually received as the ore is mined and sold. See *United States* v. *Thomas, supra; Grandview Mines* v. *CIR*, 282 F.2d 700 (9th Cir. 1960); *CIR* v. *Felix Oil Co.*, 144 F.2d 276 (9th Cir. 1944).[7]

The Tax Court relied on this line of decisions in reaching its conclusion that appellant was entitled to percentage depletion only on the amounts it actually received. While

[7] The Tax Court has followed the Ninth Circuit cases. See, e.g., *Byron H. Farwell*, 35 T.C. 454 (1960).

we do not necessarily indicate agreement with all that was said in the Ninth Circuit's opinions, we believe that the result reached is a correct one and approve its application to the facts of the instant case.

III.

The incidents of the relationship between ASARCO and appellant strongly suggest that appellant's economic interest in the Galena mining property was a non-operating interest limited to the net profit payments it actually received. Under the terms of the lease agreement, ASARCO had sole control of and was obligated to advance all capital necessary for the development and continued operation of the Galena mining property. Appellant was not liable for any part of those expenditures,[8] and ASARCO could look only to net profits for reimbursement.

Appellant itself appears to have interpreted the lease as giving it a net profits interest. During the course of negotiations, appellant's representatives wrote a letter to ASARCO stating their understanding that the lease would entitle ASARCO to a depletion deduction based on gross income less payments to appellant, while appellant's depletion allowance would be based on net profit payments received by it. Appellant suggested the inclusion of language indicating that the depletion allowance was to be divided

[8] During the last quarter of 1960, when expenses exceeded current income, 50% of the resulting loss was charged against appellant's account. Appellant cites this as evidence that it shared in the losses of the operation and therefore should be considered as having a deplefable interest in gross income from the property. These bookkeeping entries appear more likely to have been intended as a method for keeping track of the amount ASARCO was entitled to recoup from future profits on account of past losses. Appellant was never actually liable for the amounts debited to its account.

equally between the parties, a proposal ASARCO rejected.[9] Additional evidence of appellant's understanding with regard to the interest it retained under the lease agreement appears in its Annual Reports for 1959 and 1960, where its interest in the Galena mining property is characterized as "essentially 50 percent of the operating cash flow from the operation."

Appellant, however, now urges that it had considerably more than a net profits interest in the Galena mining property. Appellant points to the $500,000 working capital fund as the central feature of the lease agreement which distinguishes it from the typical net profits arrangement. The working capital fund, argues appellant, provided ASARCO with a financial "cushion" against loss which, when considered in conjunction with ASARCO's right to terminate the lease at will, effectively reduced ASARCO's risk to a minimum. Since its own interest in the fund was at stake in the event that the lease should be terminated during a period when the mine was operating at a loss, appellant concludes that in reality, to the extent that there were financial risks in the operation of the successful Galena mine, it shared in them equally with ASARCO.

Thus appellant claims that, since it shared the working interest in the Galena mining property with ASARCO, it is entitled to a depletion deduction based on the entire gross income from the property. The Tax Court, however, found that the existence of the $500,000 working capital fund, along with the termination provision, did not significantly affect the economic realities of the lease arrangement between ASARCO and appellant and accordingly determined that it was equitable to allow appellant percentage depletion only on the amounts it actually received.

The issue raised by appellant's argument, as to what sharing of risks might so shift the economic relationships under the lease agreement that it would be equitable to

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[9] Of course, the inclusion of such language would not have been binding on the Commissioner.

apportion the depletion allowance equally between the parties, is not without difficulty. Nevertheless we believe that the question of what constitutes an equitable apportionment of the depletion allowance is one of those mixed questions of fact and law where decision is so tied to the fact-finder's assessment of the proper interplay between the various factual elements and a fairly non-technical statutory standard that "primary weight" should be given to the fact-finder's conclusions. See *CIR* v. *Duberstein*, 363 U.S. 278, 289 (1960).

There is ample support for the Tax Court's determination. Appellant's risk in the working capital fund was limited to profits generated by mining operations. ASARCO, on the other hand, remained liable, even after the fund was exhausted, for all obligations incurred by it in connection with the development and operation of the mining property, and it could not escape this liability by termination of the lease agreement.[10] Moreover, we believe it preferable to view the lease as an arrangement to govern an on-going enterprise. Appellant's interest in the fund was at risk only in the event that the lease was terminated during a period when the mine was operating at a loss. As against this contingent and limited risk, appellant was at all times, regardless of the current profitability of the enterprise, guaranteed a minimum return of fifty cents per ton of ore mined. This continuing royalty feature in particular strongly supports the conclusion that appellant's economic interest in the Galena mining property was essentially a non-operating interest, not dependent on the overall profitability of the enterprise, but merely on the extraction and sale of the ore in place.

The decision of the Tax Court is affirmed.

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[10] A termination provision is not uncommon in net profit leases. See the original operating agreement at issue in *United States* v. *Thomas*, 329 F.2d 119, 123-25 (9th Cir.), cert. denied, 379 U.S. 819 (1964), which also contained a $25,000 "reserve operating fund" similar in function to the $500,000 working capital fund in this case.

APPENDIX D

Opinion of the Tax Court

51 T.C. No. 103

TAX COURT OF THE UNITED STATES

CALLAHAN MINING CORPORATION & SUBSIDIARY, PINNACLE EXPLORATION, INC.,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Docket No. 4231-66. Entered March 24, 1963.

TANNENWALD, *Judge:* Respondent determined deficiencies in the Federal income tax of petitioner as follows:

Taxable year	*Amount*
1959	$189,595.11
1960	80,275.16
1961	120,598.96

After various concessions by the parties, the principal issue remaining for decision is the determination of the proper method for computing petitioner's "gross income from mining" for purposes of percentage depletion. A subsidiary issue involves the treatment by petitioner in computing its "gross income from mining" of State net profits taxes paid for the years in question.

Appendix D

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly.

Callahan Mining Corp. (hereinafter referred to as petitioner) is an Arizona corporation with its principal office and place of business in New York, N.Y., at the time the petition herein was filed. Petitioner filed its consolidated income tax returns for the calendar years 1959 and 1960 and its separate income tax return for the year 1961 [2] on an accrual basis with the district director of internal revenue, Manhattan, New York.

Petitioner's business included, among other things, the ownership, development, and operation of mining properties on its own behalf in the Rocky Mountain area of the United States and in several Canadian provinces.

During the early 1920's, petitioner acquired a number of contiguous patented and unpatented lode claims in the Coeur d'Alene District in northern Idaho (hereinafter referred to as the Galena property) and promptly embarked upon an exploration program of such property in an attempt to make it commercially productive. Substantial sums were expended during the period 1922 to 1932. Petitioner's activities during this period included sinking of the main Galena mine shaft to a depth of 800 feet, sinking an internal shaft an additional 1,000 feet to open

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[2] The consolidated Federal income tax returns for the years 1959 and 1960 were filed by petitioner, as common parent, with Pinnacle Exploration, Inc., and Livengood Placers, Inc., subsidiaries in which petitioner owned more than 80 percent of the outstanding voting stock. Petitioner's stockholders in Pinnacle and Livengood were decreased below 80 percent on Jan. 19, 1961, and Jan. 20, 1961, respectively. Both corporations were, therefore, members of the affiliated group for less than 31 days during the taxable year beginning Jan. 1, 1961, and each elected under sec. 1.1502-13(f), Income Tax Regs., to be considered as not having been a member of the affiliated group during any part of that taxable year.

the lower levels, and substantial underground work amounting to several thousand feet.

In 1932, petitioner's management, faced with low metal prices and limited financial resources, suspended all work on the property. During 1937, petitioner again reopened the mine, and exploration work continued until 1938. This work indicated that a program to explore the potentialities of this property would involve outlays substantially in excess of petitioner's financial capacity. As a result, the Galena mine was closed again and remained inactive through 1945.

During the period from 1922 through 1938, underground work conducted by petitioner on the Galena property amounted to more than 34,000 feet and resulted in the production of 136,149 tons of low-grade ore, which was milled on the property at a loss.

In 1946, independent engineers hired by petitioner conducted a thorough examination of the Galena property. In their report to petitioner, they indicated that considerable risk would be involved in a deep exploration program but that, in view of the recently discovered valuable deep ore bodies in the vicinity of the Galena property, such risk would be warranted for those who could afford the loss if the work were to ultimately prove unsuccessful. Since, at that time, petitioner was either unwilling or unable to incur the substantial risk and expense of a deep exploration program, it commenced discussions with several major mining companies with a view towards securing outside financing for the development of the Galena property. Following extensive negotiations, the terms of a lease with American Smelting & Refining Co. (hereinafter referred to as ASARCO) were tentatively agreed upon, under which petitioner, after a certain point in time, would receive 50 percent of the net profits. Initially such lease was to cover only the western two-thirds of the Galena property.

Appendix D

During the course of the negotiations with ASARCO, petitioner's representatives wrote a letter to ASARCO's representatives stating that, as they understood the proposed lease agreement, ASARCO would be entitled to depletion of 15 percent of the gross income less payments to petitioner on account of profits, while petitioner's depletion would be limited to 15 percent of those profits. Petitioner suggested that a new paragraph be added to the proposed lease agreement to the effect that, after the parties began to share the net profits on a 50-50 basis, they would apportion the depletion allowance equally between them. Such proposal, however, was rejected by ASARCO's representatives and was not included in the lease agreement as executed.

On May 31, 1946, petitioner organized Vulcan Silver-Lead Corp. (hereinafter referred to as Vulcan) under the laws of the State of Idaho to hold that portion of the Galena property to be made subject to the lease agreement with ASARCO. Thereafter, on June 22, 1946, Vulcan received some 72 mining claims from petitioner, consisting of the western two-thirds of the Galena property, in exchange for 1,500,000 shares of Vulcan stock, constituting its then entire issued and outstanding capital stock. These claims became the nucleus of the property subjected to the lease with ASARCO (hereinafter referred to as the Galena mining property). Petitioner retained direct ownership of the remaining one-third of the Galena property. Subsequently, additional claims were acquired by Vulcan and thereafter included in the lease with ASARCO. At the time of the transfer to Vulcan, petitioner's aggregate investment in the Galena mining property (including the cost of acquisition and development expenditures) approximated $1,555,475.50.

As of January 15, 1947, Vulcan entered into a lease agreement with ASARCO (hereinafter referred to as the agreement) with respect to the Galena mining property.

Appendix D

Pursuant to the agreement, ASARCO was granted the exclusive right to explore, develop, and operate the Galena mining property for a term of 30 years with an option to renew for an additional 30 years. The relevant provisions of the agreement are as follows:

ARTICLE 3. POSSESSION AND CONTROL OF PROPERTY.

The Lessor hereby gives and grants to the Lessee the right immediately to enter upon and take over the sole and exclusive possession and control of the property * * * and during the effective term of this lease the Lessee shall remain in the sole and exclusive possession and control thereof. The Lessee is also granted the right to * * * develop, work, mine, operate, use, manage and control said property; * * * and to mine, extract and remove from said property the ores and minerals contained therein and to treat, mill, ship, sell or otherwise dispose of the same and receive the full proceeds therefrom, subject to the terms and conditions hereinafter set forth.

* * *

ARTICLE 5: WORK REQUIREMENTS.

A. The Lessee further agrees (a) to take immediate possession of the property (b) to proceed promptly with preparations necessary for the exploration thereof, (c) to pay all taxes levied against the property as provided in Article 22, * * * and (e) subject to the terms and conditions hereof, to sink a shaft on the property approximately to sea level and to drift or cross-cut at about that elevation to an extent which shall be not less than a total of five thousand (5,000) feet all in manner, method and location as determined in the sole judgment of the Lessee; and the Lessee further agrees to advance all moneys required in connection with the performance of all such agreements. Such work shall be prosecuted diligently, * * * and the Lessee shall be reimbursed therefor as provided in Article 14.

Appendix D

B. It is expressly stipulated and agreed, however, that the Lessee shall not be required to expend more than Six Hundred Thousand Dollars ($600,000) in and about the shaft and drifts or cross-cuts referred to in clause (e) of paragraph A of this Article, the work in connection therewith, and the necessary buildings and equipment, and further that, anything herein to the contrary notwithstanding, there shall be no obligation hereunder on the part of the Lessee to commence or continue any of the work requirements specified in said paragraph A if the Lessor shall be unable within a reasonable time (a) to perfect its titles to all of said unpatented lode mining claims as unpatented claims, by relocation or otherwise, as Lessee may reasonably require, or (b) if in the course of Lessee's operations hereunder heavy ground or excessive water, or the like, shall be encountered and if such conditions shall render the undertaking economically unsound or impracticable according to generally accepted good mining practice.

ARTICLE 6. TERMINATION BY LESSEE.

The Lessee reserves the right hereby expressly granted by the Lessor to terminate this lease and surrender the property to the Lessor during the term hereof (a) at any time after the sinking of said shaft to sea level and completion of five thousand (5,000) feet of drifting or cross-cutting, or (b) at any time after the Lessee shall have expended a minimum of Six Hundred Thousand Dollars ($600,000) in connection with such work, or (c) at any time that the continuation of such work shall become economically unsound or impracticable as provided in Article 5, or (d) for any reason whatever at any time during the term or extended term hereof upon fulfilment of the covenants contained in clauses (a) and (b) of this Article, upon thirty (30) days written notice to the Lessor of intention to do so.

Appendix D

ARTICLE 7. MINING OPERATIONS.

Upon completion of the shaft and drifting or cross-cutting prescribed in Article 5 the Lessee (unless this lease shall be terminated under Article 6) shall continue with reasonable diligence the exploration and development of the property, placing thereon or at other suitable location within a reasonable time all such additional mining, milling and other equipment, buildings, etc. of the kind, type, character and quality deemed advisable in the Lessee's sole judgment, advancing all moneys required for that purpose including working capital, subject, however, to the right of the Lessee to be reimbursed therefore as hereinafter provided in Article 14.

ARTICLE 8. ADDITIONAL WORK.

Nothing herein contained shall be construed to prevent the Lessee from conducting any and all such exploratory, development or mining work on the property as may seem advisable to the Lessee in its sole judgment for the benefit of the enterprise, advancing all moneys required in connection therewith; and the Lessee shall be entitled to reimbursement as provided in Article 14 for all capital expenditures in connection therewith, including all expenditures made before the property shall be placed on a profitable operating basis, operating expenditures made thereafter to be deducted in the determination of net profits under Article 15 hereof.

* * *

ARTICLE 10. TREATMENT OF PRODUCT.

The Lessee shall have the right to purchase and to treat all direct smelting ores and concentrates produced from the property at any of its smelters, * * *.

Until such time as the production of milling ores shall warrant in Lessee's sole judgment the installation of a mill

on the property or at other suitable location and such mill shall be placed in operation, the Lessee shall have the right to purchase and to treat all milling ores produced from the property at any of its mills, * * *.

ARTICLE 11. ROYALTIES.

A. Royalty Period.

The Lessee shall pay to the Lessor the royalties prescribed in paragraphs B and C of this Article until such time as the Lessor shall become entitled to share in the profits of operations as provided in Article 14; * * *.

B. Royalties on Ores, Concentrates and Tailings.

The Lessee shall pay royalties on all ores and concentrates produced and sold in an amount equal to ten per cent (10%) of the net smelter or mill returns therefrom as hereinafter defined, which royalties however shall be not less than fifty cents (50¢) per ton of crude ore; and if in addition to ores and concentrates there shall be shipped from the property tailings or similar products the Lessee shall pay to the Lessor as royalty thereon an amount equal to ten per cent (10%) of the net returns from the sale thereof to mill or smelter or other consumer, less transportation charges.

C. Royalties on Premiums and Subsidies.

In addition to the royalties aforesaid the Lessee shall pay a royalty of ten per cent (10%) on all premiums and subsidies on ores mined and removed from the property, except where by law or government regulations such premiums or subsidies or any part thereof are excluded from the computation of royalties.

Appendix D

ARTICLE 12. ADVANCE ROYALTIES.

As an advance on account of the royalties payable under Article 11 the Lessee has paid to the Lessor the sum of Four Thousand Five Hundred Dollars ($4,500), the receipt of which is hereby acknowledged; and to provide for the corporate expenses of the Lessor the Lessee agrees to further advance on account of said royalties (on the 25th day of each month) the sum of Five Hundred Dollars ($500) per month from the date hereof (a) until such time as Lessee may elect to terminate this lease as provided in Article 6(a), Article 6(b), and Article 6(c), or (b) until royalties shall be due and payable hereunder, whichever event shall occur first, provided, however, that if such royalties shall be less than Five Hundred Dollars ($500) per month the deficiency if any for the applicable quarter shall be advanced by the Lessee against royalties thereafter payable hereunder; and provided further, that all royalties in excess of One Thousand Five Hundred Dollars ($1,500) per quarter shall be retained by the Lessee until it shall have been fully reimbursed for royalties advanced hereunder.

ARTICLE 13. NET SMELTER RETURNS.

The term "net smelter returns" shall be interpreted to mean the net amount received from the smelter in payment for direct smelting ores and concentrates less cost of transportation from the mine to the smelter and smelter charges.

Net Mill Returns.

The term "net mill returns" shall be interpreted to mean the net amount received from the mill in payment for ores milled, less cost of transportation from the mine to the mill and mill charges.

Appendix D

ARTICLE 14. APPLICATION OF PROFITS.

Any and all net profits derived and determined as provided in Article 15 hereof shall be applied, first, to reimburse the Lessee for its advances or expenditures under Articles 5, 7, 8, 9, 17, 22, 23, 25, and 33 hereof (if any, not otherwise deducted in determining net profits), and second, to establish and maintain working capital in addition to that provided by the Lessee under Article 7 and in the total sum of Five Hundred Thousand Dollars ($500,000) (which shall be subject to increase or decrease from time to time by mutual agreement). Any such profits as may be in excess of the foregoing requirements shall be divided equally between the Lessor and the Lessee.

ARTICLE 15. DETERMINATION OF NET PROFITS.

"Net profits" shall be determined by deducting total expenses of whatsoever nature in connection with the operation of the property including royalties under Article 11 from the net proceeds of the crude ores and/or concentrates and other products of the property, but without deduction for depletion or depreciation; and such total expenses shall include also * * *.

* * *

(d) All taxes, assessments and governmental charges lawfully imposed upon the property or any part thereof, the operations conducted hereunder, or the sale of the product, * * * other than those for which the Lessee shall be entitled to reimbursement as provided in Article 22, and other than Federal and Idaho income taxes, net profits taxes (except property taxes based on net profits), and taxes of a similar nature, levied by such governmental instrumentality * * * upon the Lessor or the Lessee and which shall be for the account of the party directly responsible therefor.

Appendix D

ARTICLE 16. LOSSES IN OPERATION.

Any loss sustained in the operation of the property during any month shall be a charge upon first net profits thereafter derived.

ARTICLE 17. ADDITIONAL ADVANCES.

If, after the Lessee shall have been reimbursed and working capital shall have been established and maintained as provided in Article 14, it shall become necessary at any time for the Lessee in its sole judgment to advance additional funds for capital expenditures in excess of those referred to in Article 26, or to continue operations when working capital shall be depleted or exhausted, the amount of such advances shall be repaid to the Lessee out of the first profits thereafter derived with interest thereon at the rate of five per cent (5%) per annum; and if and when the Lessee shall have been so reimbursed with interest and thereafter working capital shall have been established again in the amount prescribed in Article 14, profits shall then be divided equally between the Lessor and the Lessee; provided, however, that if the Lessee shall elect to make advances hereunder to continue operations at a loss to the mine, there shall be paid to the Lessor during such period a royalty of fifty cents (50¢) per ton of crude ore produced from the property and sold or otherwise disposed of, it being expressly stipulated and agreed that such payments and losses by the Lessee shall constitute an advance or expenditure for which it shall be entitled to reimbursement as hereinabove provided.

* * *

Appendix D

ARTICLE 22. PAYMENT OF TAXES.

The Lessee shall pay or if the Lessor shall have paid the Lessee shall reimburse the Lessor for all taxes upon said property falling due during the term of this lease and while the same is in force and effect * * * and shall also pay, * * * all taxes levied or assessed against any and all personal property, machinery and equipment placed upon said property by the Lessee during the term of this lease. The Lessee shall be liable for and undertakes to pay all sales taxes and other taxes of every kind, character and description levied or imposed during the term of this lease upon the ores, minerals, concentrates or products of ores produced, sold or otherwise disposed of by the Lessee * * * and the Lessee shall be entitled to reimbursement for all taxes paid hereunder as provided in Article 14 until the property shall be placed on a profitable operating basis when the same shall be deducted in determining net profits as provided in Article 15. * * *

ARTICLE 26. REPLACEMENTS.

If at any time during the period of this lease capital expenditures shall be required in the Lessee's sole judgment for the benefit of the operations contemplated herein, in addition to those made before the property shall be placed upon an operating basis * * * the parties hereto agree that any such capital expenditures in an amount not exceeding in the aggregate Seventy-Five Thousand Dollars ($75,000) in any one calendar year shall be deemed expenses in connection with the operation of the property and as such shall be deducted in determining "net profits" as provided in Article 15 hereof.

* * *

Appendix D

ARTICLE 29. SURRENDER OF PROPERTY.

Upon termination of this lease * * * the Lessee shall * * * surrender possession of the property and pay all bills or other obligations incurred by it in connection therewith and all royalties or profits due to the Lessor up to the date of such termination.

In the event that such termination shall occur before the property is placed upon a profitable operating basis, the Lessee shall have the right to remove from the property the equipment, materials and supplies placed thereon by it, subject, however, to the right of the Lessor to purchase [certain of the equipment, materials and supplies on the basis of cost].

In the event, however, that such termination shall occur after the property shall have been placed upon a profitable operating basis but before the Lessee shall have been fully reimbursed for its expenditures * * * then any cash available in the working capital account shall be applied to so reimburse the Lessee, and the Lessee shall have the further right to remove from the property equipment, materials and supplies of a fair market value not exceeding the amount required for such reimbursement, subject, however, to the right of the Lessor to purchase any of such equipment, materials and supplies at the then fair market value thereof.

If, however, the Lessee shall have been previously so fully reimbursed, or shall be so fully reimbursed through the application of working capital as hereinabove provided, then the amount of any remaining working capital shall be divided equally between the Lessor and the Lessee, and for that purpose the equipment, materials and supplies remaining on the property shall be sold or otherwise disposed of on the basis of the best terms available.

Subsequently, by an agreement dated June 4, 1959, article 17 of the agreement was amended to read as follows:

Appendix D

ARTICLE 17. ADDITIONAL ADVANCES.

(a) If, after the Lessee shall have been reimbursed and working capital shall have been established and maintained as provided in Article 14, it shall become necessary at any time for the Lessee in its sole judgment to advance additional funds for capital expenditures in excess of those referred to in Article 26, or to continue operations when working capital shall be depleted or exausted, the amount of such advances shall be repaid to the Lessee out of the first profits thereafter derived with interest thereon at the rate of five per cent (5%) per annum; and if and when the Lessee shall have been so reimbursed with interest and thereafter working capital shall have been established again in the amount prescribed in Article 14, profits shall then be divided equally between the Lessor and the Lessee.

(b) Notwithstanding the provisions of Articles 16 and 17(a), if, during any calendar quarter in which the property has been operated by the Lessee, there are no net profits, or the share of net profits payable in cash to the Lessor is less than 50 cents per ton of crude ore produced from the property and sold, removed from the property or milled at the property during such quarter, then, for such calendar quarter, the Lessee shall pay to the Lessor, as an advance against the Lessor's share of future net profits, a sum equal to the difference between (1) the Lessor's share of net profits (if any) for said quarter and (2) the sum of 50 cents per ton of said crude ore; (but not more than 50 cents per ton). Such advances to the Lessor shall be chargeable against and deducted from the Lessor's share of net profits in any future calendar quarter to the extent that such share exceeds a minimum of 50 cents per ton of crude ore produced from the property and sold, removed from the property or milled at the property during such quarter, until all such advances have been deducted in full. Except by charge against and deduction from the Lessor's

share of future net profits as aforesaid, the Lessor shall not be liable to repay Lessee for such advances. * * * In the event of termination of this lease with any advances by the Lessee under this Article 17(b) still outstanding, the same shall be regarded as expenditures for which Lessee shall be entitled to reimbursement under the provisions of the third paragraph of Article 29 hereof.

Since 1947, ASARCO has continued to operate the Galena mining property under the agreement with its own employees and management team.[3] The ores mined from the Galena mining property by ASARCO have been sent to ASARCO's smelters and refineries and the resulting products have been sold by it to third parties. Since 1947, petitioner has never received any of the ores or concentrates in kind.

In operating the Galena mining property, ASARCO has continued to use the same two shafts originally constructed and used by petitioner; however, ASARCO extended the depths of the original shafts to lower rock formations, where ore in commercial quantities was found, and in 1961 sank a new shaft on the property. ASARCO invested substantial amounts in the exploration, development, and equipping of the Galena mining property.

As of April 30, 1958, Vulcan was merged into petitioner, with the result that petitioner again became the owner of the Galena mining property, subject to the agreement.

From 1953 to 1959, ASARCO made payments to Vulcan or petitioner, in accordance with article 11 of the agreement, in the following annual amounts:

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[3] On April 2, 1947, however, ASARCO assigned one-quarter of its interest to Fern Mining Co., which interest was subsequently assigned to Day Mines, Inc., its present owner. This assignment has no bearing on the issues involved herein.

Appendix D

Year	Amount
1953	$ 46,940
1954	92,738
1955	176,466
1956	274,073
1957	378,040
1958	424,107
1959	95,229
Total	$1,487,593

For Federal income tax purposes, Vulcan and petitioner reported these payments as its depletable income, and ASARCO, until it had been fully reimbursed for all prior advances, reported the gross income from the property, less the payments, as its depletable income.

ASARCO's unreimbursed expenditures for the operation of the Galena mining property reached $3,641,079 by December 31, 1954. After that date, the operation began to show a profit and reimbursements to ASARCO began.

By January 1959, sufficient net profits had been generated from the operation of the Galena mining property to reimburse ASARCO for all its prior expenditures, including amounts paid by it to Vulcan or petitioner, and to establish working capital of $500,000 (hereinafter referred to as the "working capital account"), pursuant to article 14 of the agreement. While this working capital account was being established in 1958 and 1959, petitioner continued to receive payments under article 11 of the agreement, which payments were deducted in determining net profits. Since the establishment of the working capital account in 1959 and during all years here in issue, petitioner and ASARCO have divided net profits equally.

Appendix D

The working capital account is represented by inventories, supplies, accounts receivable, and other current assets readily convertible into cash and needed in the operation of the property.

In 1958 and 1959, the parties to the agreement treated the $500,000 working capital account for Federal income tax purposes as follows: ASARCO included in its gross income, and claimed depletion for 75 percent of, $250,000. Neither petitioner nor ASARCO included in gross income, or claimed depletion on, the other $250,000.[4]

During late 1959 and early 1960, the smelters serving the Galena mines went on strike, thus causing ASARCO to make additional advances of approximately $800,000 over and above the $500,000 working capital account previously established. These advances were subsequently recovered by ASARCO from future net profits.[5]

Petitioner received net profit payments from ASARCO pursuant to the agreement in the following annual amounts:

Year	Amount
1959	[1] $534,501
1960	586,048
1961	838,778

[1] Also in 1959, petitioner received $95,229 from ASARCO under article 11 of the agreement.

Petitioner's published financial statements for 1959, 1960, and 1961 showed as income from the Galena min-

[4] Day Mines, Inc., including in its gross income, and claimed depletion on, 25 percent of the full $500,000. See fn. 3, *supra*.

[5] Such advances bore no interest, because they only served to increase working capital. Under article 17 of the agreement, advances bore interest only if made for capital acquisitions or improvements or only if the working capital was exhausted and current profits were insufficient.

ing property only the amounts actually received from ASARCO. In its annual reports for 1959 and 1960, petitioner characterized its interest in the Galena mining property as "essentially 50 percent of the operating cash flow from the operation."

On its Federal income tax returns for the years 1959, 1960, and 1961, petitioner computed and claimed percentage depletion deductions on the Galena mining property as follows:

Year	Gross income from sales	Amounts applied to working capital and capital expenditures	Gross income adjusted as claimed by petitioner	Petitioner's claimed share (50%)	Petitioner's claimed depletion (15%)
1959	$3,236,841	($63,324)	$3,173,517	$1,586,758	$238,013
1960	3,423,857	(79,555)	3,344,302	1,672,151	250,822
1961	4,568,077	(1,551)	4,566,526	2,283,263	342,489

Respondent, in his notice of deficiency herein, determined that petitioner was entitled to depletion deductions based on 15 percent of the amounts actually received by petitioner from ASARCO, i.e., $618,730 in 1959, $586,047 in 1960, and $838,778 in 1961.

On its Federal income tax returns for the year 1959, 1960, and 1961, ASARCO included in gross income, and claimed depletion at the rate of 15 percent on, the total gross income from the Galena mining property, less payments made to petitioner and $250,000 of the working capital account accumulated in 1958 and 1959. Respondent subsequently disallowed depletion claimed by ASARCO to the extent that such depletion, when added to the depletion claimed by petitioner, would exceed 15 percent of the total gross income from the Galena mining property.[6]

[6] There is no evidence in the record herein indicating whether ASARCO made any claim with respect to ths acton by respondent, or, if it did, what disposition was made thereof.

Appendix D

Neither petitioner nor ASARCO has ever filed joint venture or partnership income tax returns with reference to the Galena operations.

Pursuant to section 63-2801 *et seq.* of the Idaho Code, the State of Idaho levies an annual personal property tax measured by the annual net profits of mining ventures (hereinafter referred to as the net profits tax).

In years prior to 1958, Vulcan was billed directly by the State of Idaho for, and paid a portion of, the net profits tax of the Galena operation, measured by the amount of annual payments it received from ASARCO; ASARCO paid the balance and included such balance in reimbursable expense in computing "net profits" under article 15 of the agreement. Vulcan claimed that this resulted in an inequitable burden on it, in that it was bearing both 100 percent of the taxes it had paid and 50 percent of the taxes paid by ASARCO. In 1957, through negotiation and correspondence between the parties, it was agreed that 100 percent of the Idaho net profits tax should be a charge against the Galena operations and thus borne equally by Vulcan and ASARCO.

For the years 1959, 1960, and 1961, the net profits taxes levied by the State of Idaho on the Galena operation amounted to $98,472, $93,971, and $156,523, respectively, which taxes were paid by ASARCO and deducted in computing the "net profits" from the property in which petitioner was entitled to share.

On its Federal income tax returns for the years 1959, 1960, and 1961, petitioner included in its gross income a 50-percent share of the amount expended for the Idaho net profits tax and took depletion thereon.

OPINION

The principal issue herein is *the measure* of the amount upon which petitioner is entitled to compute percentage de-

pletion for the taxable years 1959, 1960, and 1961 with respect to the Galena mining property. There is no question that petitioner's "net profits" share in the gross income from the property constitutes an economic interest sufficient to support such a deduction. *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25 (1946); *Kirby Petroleum Co.* v. *Commissioner*, 326 U.S. 599 (1946). The governing statutory provisions are sections 611(a) and 611(b)(1) of the Internal Revenue Code of 1954.[7]

Petitioner maintains that under "the peculiar conditions" of this case (sec. 611(a)) and in order to reflect an "equitable" apportionment as required by section 611(b)(1), it should include 50 percent of the *total gross income* from the property in its gross income and compute its depletion deduction thereon.[8] Respondent, on the other

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[7] SEC. 611. ALLOWANCE OF DEDUCTION FOR DEPLETION.

(a) GENERAL RULE.—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. * * *.

(b) SPECIAL RULES.—

(1) LEASES.—In the case of a lease, the deduction under this section shall be equitably apportioned between the lessor and lessee.

[8] Petitioner recognizes that the logic of its position might require the conclusion that, during the pre-1959 period, it should have included in its gross income, and taken depletion on, 50 percent of amounts of gross income from the Galena mining property which was used to reimburse ASARCO for capital outlays and to establish the working capital fund. For reasons which will subsequently appear, we find it unnecessary to delve into the issues which inhere in this problem.

hand (and ASARCO, which filed briefs *amicus curiae*) contends that the proper amount to be included in petitioner's gross income and upon which the depletion deduction should be computed is 50 percent of the *net profits* from the property, i.e., the amounts actually received from ASARCO. We agree with respondent.

Petitioner contends that, at least at the point of time in 1959, when the $500,000 working capital fund had been accumulated, it and ASARCO, for all practical purposes, had an equal stake in the success or failure of the Galena mining property, each item of income, expense, and capital expenditure being attributable to and or borne equally by the two parties. It urges that, during the period involved herein, ASARCO was no more at risk than petitioner because of the proven profitability of the property, the working capital account, and ASARCO's right to terminate the lease at any time. It is thus urged that petitioner and ASARCO were, *in effect*, "equal co-venturers"[9] during the years in question and should divide the depletion allowance equally in those years.

Petitioner recognizes that, aside from the aforementioned potential inclusion of additional amounts in prior years (see fn. 8, *supra*), it properly included in its gross income, and used as the base for computing depletion, only the amounts which it actually received from ASARCO during the recoupment period. *United States* v. *Cocke*, 399 F. 2d 433 (C.A. 5, 1968), overruling en banc *Commissioner* v. *J. S. Abercrombie Co.*, 162 F. 2d 338 (C.A. 5, 1947), affirming 7 T.C. 120 (1946), and *Prater* v. *Commissioner*,

[9] Despite petitioner's use of such phrases to "co-venturer" and "co-partner" at the trial and in the briefs, it does not maintain (and, indeed, we do not think it could have so maintained) that a joint venture or partnership, as those relationships have been legally defined, actually existed in the instant case. E.g., *Grandview Mines* v. *Commissioner*, 282 F. 2d 700 (C.A. 9, 1960), affirming 32 T.C. 759 (1959).

273 F. 2d 124 (C.A. 5, 1959), reversing 30 T.C. 1262 (1958); *United States* v. *Thomas*, 329 F. 2d 119 (C.A. 9, 1964), an en banc decision overruling *Helvering* v. *Armstrong*, 69 F. 2d 370 (C.A. 9, 1934); [10] *Manahan Oil Co.*, 8 T.C. 1159 (1947); see *Byron H. Farwell*, 33 T.C. 454, 468 (1960), in which *Abercrombie* and *Prater* were distinguished and severely limited in their application. Petitioner asserts, however, that these decisions are not determinative of the proper allocation of gross income from the property during the postrecoupment period and that, in the context of this case, *Abercrombie*, *Prater*, *Armstrong*, and *McMurray* (see fn. 10, *supra*) retain their vitality and support petitioner's contention that the existence of personal liability on the part of the lessor for its share of the ongoing costs and expenses of the operation is not the touchstone of decision.

We think that petitioner's view is myopic. The totality of petitioner's relationship with ASARCO must be considered, not simply the actual results during any one period of operation. Cf. *United States* v. *White*, 401 F. 2d 610 (C.A. 10, 1968). Looked at in this ken, petitioner and ASARCO were not on as equal a footing as petitioner would like us to believe.

It is clear from the agreement—and petitioner does not contend otherwise—that ASARCO had all the operating rights and duties in the Galena mining property, including the right to extract and dispose of the minerals therefrom. With respect to liability for costs or expenses of production, ASARCO was obligated to furnish, in the first instance, all capital for exploration, development, and operation of the property. Under the agreement, it could

[10] The same transaction involved in this case was also the subject of a decision in favor of the lessor in *Reynolds* v. *McMurray*, 60 F. 2d 843 (C.A. 10, 1932). Although not technically overruled, the *McMurray* case was made moribund by *Cocke* and *Thomas*.

look only to the net profits from production for reimbursement of these outlays. After the property reached a profitable stage, while petitioner admittedly shared costs and expenses to the extent of its interest in net profits, it was under no personal obligation to contribute to or bear any portion of such costs and expenses. Granted that *United States* v. *Cocke*, *supra*; and *United States* v. *Thomas*, *supra*, did not necessarily decide that the absence of personal liability was the determining factor, the fact remains that the courts continue to regard personal liability as an important factor in the allocation of the depletion allowance. *United States* v. *Thomas*, 329 F. 2d at 130; cf. *Weinert's Estate* v. *Commissioner*, 294 F. 2d 750 (1961), reversing and remanding on other grounds 31 T.C. 918, 928 (1959); *Manahan Oil Co.*, *supra*.[11]

Petitioner itself recognizes that the personal liability element is significant but contends it should be denigrated in this case because of the existence of the $500,000 working capital fund. Petitioner's syllogism proceeds along the following lines: (a) If there had not been a provision for the establishment of such fund, it would have received "net profit" payments of $250,000; (b) one-half of the working capital fund was consequently represented by its money; (c) the fund assured ASARCO of the means to operate the property under normal circumstances and provided a reserve against future losses; (d) therefore, during the period in question, it shared equally with ASARCO in the financial burdens and risks. We reject this deductive logic. Concededly, if there had not been such a provision, petitioner would have received additional net profits and would have been entitled to a larger deduction for depletion, i.e., on the larger amount received. But it does not follow that the establishment of that fund there-

[11] See Caplan, "Taxation of Carried Interests: A Study in Gossamer Distinctions," 7 S. Tex. L.J. 239, 265 (1964).

after enlarges petitioner's base for depletion into a greater amount of income which it did not receive. The fact is that, even assuming that one-half of the working capital fund belonged to petitioner during the operations of the Galena mining property (an issue which we do not decide, see p. 1021, *infra*), whatever risk it had was limited to profits generated by the venture.

ASARCO, on the other hand, was still faced with the likelihood that it would have to put up funds beyond its share of the profits from the venture in order to keep the operations going. Indeed, as late as 1959 and 1960, a smelter strike necessitated ASARCO's putting up approximately $800,000. Granted that ASARCO subsequently recovered these outlays from net profits, it was ASARCO, and ASARCO alone, which bore the risk that such profits might never materialize. What is even more significant is that, at the very moment in 1959 when operations turned the corner and petitioner was scheduled to move from 50 cents per ton to a "net profits" payment, article 17 of the agreement was amended to provide that petitioner should receive 50 cents a ton in any calendar quarter when the net profits from operations fell below this amount.[12]

Nor are we impressed with petitioner's argument that, because ASARCO had the right to terminate the agreement, the existence of the working capital fund during the period in question gave ASARCO the capability to "pull the 'plug'" and come out whole, thereby minimizing

[12] Petitioner attached to a supplemental brief a voucher of ASARCO which showed that the property had losses during the last two quarters of 1960. During this period, mining operations were at a standstill because of a strike, so that the provision for a guaranteed minimum payment was not operative. But neither was petitioner called upon to make good its share of those losses. Rather, they were deducted from petitioner's share of net profits for the first quarter of 1961.

ASARCO's risk. A termination clause is not uncommon in leases of the type involved herein, and there has been no indication that the courts attach any significance thereto. E.g., *United States* v. *Thomas, supra.*

In short, even in the years at issue, ASARCO, and not petitioner, bore the ultimate risk of nonprofitability. The working capital fund at best provides the roof for a depletion structure from which the foundation and walls are missing.[13] Under the circumstances of this case, we conclude that an allocation of the depletion deduction to petitioner based upon the amounts it actually received best satisfies the mandate of equitable apportionment under section 611(b)(1). We are reinforced in our conclusion by the fact that every decision which retains its vitality and which has considered the question has concluded that, even in the postrecoupment period, the holder of a net profit interest is entitled to depletion only on the *amounts he receives*, and not on a percentage of gross income. *United States* v. *Thomas, supra*; *Grandview Mines* v. *Commissioner*, 282 F. 2d 700 (C.A. 9, 1960), affirming 32 T.C. 759 (1959); *Commissioner* v. *Felix Oil Co.*, 144 F. 2d

[13] In *United States* v. *Thomas*, 329 F. 2d 119, 128 (C.A. 9, 1964), the parties provided for a $25,000 "reserve operating fund" to be established from the "net proceeds" from operations, which fund is analogous to the working capital account herein, but the court gave no weight to that factor in assessing the economic realities of the arrangement. Petitioner seeks to strengthen its argument as to the working capital fund by speculating that, if and when its share of that fund is paid to it at a later date, it may not be entitled to the full benefit of depletion thereon because of insufficient net profits from the operations in the year of payment. We need not join in the speculation since the problem is not now before us. Suffice it to say that the mere possibility of future difficulties cannot justify departure from a clearly indicated conclusion herein. Similar considerations are involved with respect to the proper treatment if and when petitioner receives its share of amounts expended for capital outlays for equipment, etc. Cf. sec. 109.

276 (C.A. 9, 1944), affirming a Memorandum Opinion of this Court; *Byron H. Farwell, supra; Marrs McLean*, 41 B.T.A. 565 (1940). Our conclusion was also foreshadowed by *Kirby Petroleum Co. v. Commissioner, supra*, where the Supreme Court, in deciding that a share in net profits constituted an "economic interest" sufficient to support a depletion allowance, stated (326 U.S. at 604): "We think these taxpayers had an economic interest in the oil, sufficient to support depletion *on the sums received as net profit.*" (Emphasis added.)

Petitioner seeks to avoid the impact of these decisions by constructing distinctions based upon the existence therein of a "carried" or "royalty" as distinguished from a "net profits" interest and upon the proposition that a coownership rather than a lessor-lessee relationship was involved. Whatever may be the ramifications of these distinctions in another context, they are not applicable to the circumstances of this case. Compare *Kirby Petroleum Co. v. Commissioner*, 326 U.S. at 604-606; *Byron H. Farwell*, 35 T.C. at 468; Hambrick, "Another Look at Some Old Problems—Percentage Depletion and the ABC Transaction," 34 Geo. Wash. L. Rev. 1 1966).

The depletion allowance manifests a congressional intent to encourage the discovery and development of new resources and to grant concessions to those who risk their capital in that pursuit. See 65 Cong. Rec. 2799 (1924); H. Rept. No. 1, 69th Cong., 1st Sess., p. 6 (1920). We think this intent is more fully effectuated by the allocation of the depletion allowance as urged by respondent, since it is ASARCO, and not petitioner, who supplied the capital and bore the risk of the Galena operation. We are not persuaded that we should accept petitioner's contention that there was a sufficient sharing of costs and expenses (see *United States v. Cocke*, 399 F.2d at 436) at the end of the recoupment period to justify the adoption of a "shifting

use" concept in determining petitioner's base for computing depletion.

We therefore hold that petitioner should compute its depletion deduction based on 15 percent of the amounts actually received by it from ASARCO as net profits during the years in issue. In so holding, we inter our decision in *Abercrombie* as the Fifth Circuit Court of Appeals has done with its prior affirmance of that decision. *United States* v. *Cocke*, *supra*.

The parties have agreed that, in the event of such a holding, petitioner will not be considered as having received, in the pre-1959 period, any portion of the net profits which were used to accumulate the $500,000 working capital fund.[14] As a result, petitioner is not required to increase its net income for 1958 to reflect such portion. This agreement, coupled with a concession by respondent with respect to petitioner's dividend received deduction for 1958, disposes of the issue involving the amount of the petitioner's loss carry forward from that year.

We turn now to the final issue which requires decision, namely, to what extent is the petitioner entitled to include in its gross income, and take depletion on, the Idaho net profits tax paid by ASARCO and charged against the income from the operation of the Galena mining property pursuant to the agreement in the years in question? The parties are in agreement that resolution of this issue turns upon the extent of petitioner's liability under State law for the tax involved and that the fact that ASARCO paid the tax is not determinative. If a lessor of mineral interests is so liable, the payment by the lessee pursuant to the terms of the lease agreement is considered a defrayal of the lessor's obligation; the amount paid (whether by way of a

[14] No issue has been raised as to the separate treatment of amounts expended for capital outlays during the pre-1959 period or the years in issue herein. See fn. 8, *supra*.

fixed payment per ton or a percentage of net profits) constitutes additional amounts paid to the lessor and is includable in the lessor's, and not the lessee's, gross income subject to depletion. *Louisiana Land & Exploration Company* v. *Donnally*, 394 F. 2d 273 (C.A. 5, 1968) (Louisiana); *Handelman* v. *United States*, 357 F. 2d 694 (Ct. Cl. 1966) (Minnesota); *Burt* v. *United States*, 170 F. Supp. 953 (Ct. Cl. 1959) (Minnesota); *Winifred E. Higgins*, 33 T.C. 161 (1959) (State not apparent); *United States Steel Corporation* v. *United States*, 270 F. Supp. 253 (S.D.N.Y. 1967) (Minnesota). In all of these cases, the courts found that the lessor was liable for the entire State tax and determined the right to depletion accordingly. Petitioner herein has not claimed that it had liability for more than one-half of the Idaho net profits tax and we therefore confine our attention to that claim and proceed to consider the applicable Idaho law.

Section 63-2801 of the Idaho Code imposes a tax on "the net annual proceeds of all mines and mining claims." It appears, and the parties do not argue otherwise, that "net annual proceeds" are equated with "net profits," which phrase is defined in section 63-2802.[15] Pursuant to

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[15] 63-2802. Net profits defined.—The term "net profits," as employed in this chapter, means the amount of money received from the mining of said metals or minerals from said mine or mining claim, after the deduction of the actual expenditure of money and labor in and about extracting the metals and minerals from the mine or mining claim, and transporting the same to the mill, concentrator or reduction works, and the reduction thereof, and the conversion of the same into money, or its equivalent, and also the deduction of all moneys expended for necessary labor, machinery and supplies needed and used in the mining operations, for the improvements necessary in and about the mine or mining claim, for reducing ores, for the construction of the mills and reduction works used and operated in connection with the mine or mining claim, for transporting the ore, and for extracting the metals and minerals therefrom; but the money invested in the mine, or improve-

the provisions of section 63-2803, "Every person, corporation or association engaged in mining" is required to file an annual "statement of the net profits derived from the mining of said metals or minerals, from each mine or mining claim owned or worked by such person." The tax is collected by assessment of the county assessor (secs. 63-2808, 63-2809, and 63-2710) and every such tax is a lien upon the mine or mining claim from which the ores or minerals are extracted.

The Idaho tax has been described as a *property tax* on the several minerals, with the net profits simply being the base upon which the tax is imposed. Op. Atty. Gen. Idaho (Nov. 18, 1957). This position is supported by the facts that the determination of net profits permits the deduction only of the costs directly involved in extraction (sec. 68-2802), that the rate of tax is not specified as is usually the case with an income or profits tax, that the tax is assessed and is made subject to equalization in the manner as provided "for the assessment of other property" (sec. 63-2810), and that the "tax is made a lien on the property" (sec. 63-2811).

Although the responsibility for filing a statement of net profits appears to rest with the mining operator under section 63-2803, we are convinced that the reporting requirement and liability for the tax are not necessarily coextensive. We are reinforced in this conclusion by the fact that, prior to the agreement between ASARCO and petitioner in 1957 regarding ASARCO's payment of the full amount of the tax subject to the inclusion of this payment in the net profit computation, the State of Idaho assessed the tax against both petitioner and ASARCO to the extent of their

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ments made during any year except the year immediately preceding such statement, must not be included therein. Such expenditures do not include the salaries, or any portion thereof, of any person or officers not actually engaged in the working of the mine, or personally superintending the management thereof.

respective interests in the profits of the venture.[18] Moreover, if the tax were assessed against only one party to the venture, without regard to its right to retain the profits upon which the tax is based, the tax levied could exceed that party's actual share of net profits. Such a view of the incidence of the net profits tax could produce an absurd result.

While we, unfortunately, do not have the benefit of any decided cases on the extent of a lessor's liability for the Idaho net profits tax, we are satisfied that the highest court of Idaho would hold that petitioner's ownership in the several minerals for the purposes of the Idaho net profits tax would be the same as its entitlement to net profits under the agreement, i.e., 50 percent, and that petitioner was therefore liable for the tax on its share of those profits used by ASARCO to pay such tax. *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967). Accordingly, under the authority of the cases previously cited (see p. 1021, *supra*), we hold that ASARCO's payment of petitioner's share of that tax pursuant to the agreement is includable in petitioner's gross income subject to depletion.

Reviewed by the Court.

Decision will be entered under Rule 50.

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[18] Since 1955, the Galena operation has produced profits subject to the Idaho tax. However, because in the years 1955, 1956, and 1957 the prerequisites to the 50-50 splitting of net profits as provided in Article 14 had not been met, petitioner instead received payments pursuant to Article 11. These payments were used in the basis of the assessment of the net profits tax against petitioner.

APPENDIX E

Statutory Provisions and Regulations

Internal Revenue Code of 1954, §§ 611(a), 611(b)(1), 613(a), and 613(b)(3)(A), 26 U.S.C. §§ 611(a), 611(b)(1), 613(a), 613(b)(3)(A), appearing in 68A Stat. 207, 208.

§ 611. Allowance of Deduction for Depletion

(a) General rule.—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. For purposes of this part, the term "mines" includes deposits of waste or residue, the extraction of ores or minerals from which is treated as mining under section 613(c). In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this section for subsequent taxable years shall be based on such revised estimate.

(b) Special rules.—

(1) Leases.—In the case of a lease, the deduction under this section shall be equitably apportioned between the lessor and lessee.

* * *

§ 613. PERCENTAGE DEPLETION

(a) General rule.—In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). For purposes of the preceding sentence, the allowable deductions taken into account with respect to expenses of mining in computing the taxable income from the property shall be decreased by an amount equal to so much of any gain which (1) is treated under section 1245 (relating to gain from disposition of certain depreciable property) as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231, and (2) is properly allocable to the property. In no case shall the allowance for depletion under section 611 be less than it would be if computed without reference to this section.

(b) Percentage depletion rates.—The mines, wells and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

* * *

(3) 15 percent—

(A) metal mines (if paragraph (2)(B) does not apply), rock asphalt, and vermiculite; and

* * *

Regulations of the Internal Revenue Service, Department of the Treasury, § 1.611-1(2)(2), 26 CFR 1.611-1(c)(2), at page 189.

§ 1.611-1(c)(2)

(2) Leases. In the case of a lease, the deduction for depletion under section 611 shall be equitably apportioned between the lessor and lessee. In the case of a lease or other contract providing for the sharing of economic interest in a mineral deposit or standing timber, such deduction shall be computed by each taxpayer by reference to the adjusted basis of his property determined in accordance with sections 611 and 612, or computed in accordance with section 613, if applicable, and the regulations thereunder.